Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

REPLY COMMENTS

OF THE

CALIFORNIA CABLE TELEVISION ASSOCIATION

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SUMMARY

In 1990, the FCC embarked on a bold experiment to test whether a new form of regulation, dubbed "price-cap regulation," could induce the LECs to become more efficient providers of telecommunications services and thereby ultimately offer consumers lower-cost, higher-quality telecommunications services. With over three years of experience under the new regulatory regime, the FCC has now asked parties to help it to make recommendations for revisions to the price-cap framework that would better accomplish the Commission's goals.

The LECs urge the Commission to move to a "pure price-caps" approach that eliminates what they see as "vestiges" of traditional cost-of-service regulation. Customers and competitors of the LECs recommend that the Commission fine-tune the existing price-cap framework that gives customers a larger proportion of the benefits of price-cap regulation than has been the case thus far.

CCTA agrees with those customer and competitor parties that have summarily rejected the LECs' vision of "pure" price caps. The alleged efficiency incentives of pure price caps will deliver little in the way of tangible consumer benefits if the cost savings of productivity improvements are never passed through in actual rates paid by LEC customers. Neither customers nor competitors will be better off if the LECs are able to "tax" their monopoly telephone customers (through a reduced productivity factor) to fund their infrastructure upgrades, while current and potential LEC competitors, such as competitive access

providers and cable television systems, must finance their network improvements with shareholder or bondholder dollars.

The true promise of price-cap regulation will best be fulfilled if the FCC focuses its efforts on fine-tuning the parameters of the existing price-cap framework to provide a better balance between customer and LEC shareholder interests and could yield larger consumer dividends.

CCTA asks the Commission to make the following findings:

- To date, price-cap regulation has failed to produce rate reductions in excess of those that would have been expected due to a combination of competitive forces and the operation of traditional cost-of-service regulation.
- To ensure consumer benefits from price-cap regulation, the FCC must fine-tune the parameters of the current price-cap formula. Specifically, **the FCC must adopt a new benchmark ROR no greater than 10.00% and should consider increasing the productivity factor.**
- To provide just and reasonable rates and to avoid cross-subsidization and anti-competitive behavior, **the FCC must adopt a one-time rate reduction reflecting the difference between the new benchmark ROR and the current 11.25% benchmark ROR**, in addition to using the new benchmark ROR to reset the thresholds for the low-end adjustment and sharing mechanisms.

- To provide continued protection against the uncertainties inherent in the establishment of the price-cap parameters, especially the productivity factor, **the FCC must retain the sharing mechanism at this time.**
- To ensure that the price-cap formula works as intended, **the FCC must prevent the LECs from using changes in depreciation rates to affect rates** and must continue to prescribe depreciation rates to be used in calculating shareable earnings.
- To protect ratepayers against excessive rates, **the FCC must not reduce its regulatory scrutiny over the LECs' prices except in those markets in which the LECs can demonstrate that at least 50 percent of customers have competitive alternatives available to them and competitors have obtained at least a 15 percent market share.**

The FCC should firmly reject LEC efforts to re-link rates with LEC investment on the basis of LEC pleas that certain changes in the Commission's price cap plan (e.g. a reduction in the productivity factor) would provide greater incentives to invest in the national information infrastructure. This is contradictory to the premises of price caps, and would amount to a tax on the general public to fund the NII.

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The California Cable Television Association ("CCTA") hereby responds to the opening comments on proposed modifications to the price-cap regime filed with this Commission on May 9, 1994. The opening comments revealed a widespread belief that the price-cap experiment has demonstrated the *potential* for substantial public interest gains as compared with traditional cost-of-service regulation. Not surprisingly, however, they also uncovered a great divergence of opinion between the Local Exchange Carriers ("LECs") and their customers and competitors as to the types of modifications that would best achieve the promise of price-cap regulation.

In these reply comments, CCTA focuses again on several key parameters of the price-cap framework: (1) the benchmark rate of return ("ROR"), (2) the productivity adjustment factor, (3) the sharing and low-end adjustment mechanism, and (4) the treatment of depreciation expenses. CCTA also addresses the LECs' claims that the current level of competition justifies a more relaxed form of LEC regulation.

CCTA's reply comments on the benchmark ROR are supported by the attached Reply Affidavit of Terry L. Murray on cost of capital issues. Ms. Murray also provided CCTA with expert analysis of all of the other issues addressed in this docket, and her analysis is fully reflected in these reply comments. Ms. Murray is an economist and former Director of the Division of Ratepayer Advocates at the California Public Utilities Commission ("CPUC").[1/] A number of CCTA's suggestions in these reply comments are based on CCTA's experience in the CPUC's recent review of its own intrastate price caps plan.

I. INTRODUCTION AND SUMMARY

In 1990, the FCC embarked on a bold experiment to test whether a new form of regulation, dubbed "price-cap regulation," could induce the LECs to become more efficient providers of telecommunications services and thereby ultimately offer consumers lower-cost, higher-quality telecommunications services. With over three years of experience under the new regulatory regime, the FCC has now asked parties to help it to determine the success of the experiment thus far and to make recommendations for revisions to the price-cap framework that would better accomplish the Commission's goals.

[1/]Since leaving the CPUC in 1990, Ms. Murray has served as a consultant and expert witness before state and federal regulatory commissions on incentive regulation, competition policy and costing and pricing issues, as well as cost of capital issues. Her qualifications are included as Exhibit 1 to her Reply Affidavit.

The sheer volume of the opening comments indicated the timeliness and importance of this review. Virtually all of the parties saw merit in the price-cap concept, but nearly all believed that the framework should be revised in one or more respects. The LECs urge the Commission to move to a "pure price-caps" approach that eliminates what they see as "vestiges" of traditional cost-of-service regulation. Customers and competitors of the LECs recommend that the Commission fine-tune the existing price-cap framework that gives customers a larger proportion of the benefits of price-cap regulation than has been the case thus far.

The LECs' idea of "pure price-caps" is a simple one: First, let the LECs earn more money (by reducing the productivity adjustment factor and foregoing any rate adjustment for the major decline in interest rates and the cost of capital since the price-cap framework was first adopted). Then, let the LECs keep all the money they earn (by eliminating the sharing mechanism that requires LECs to share earnings in excess of their cost of capital with customers). Such a scheme, goes the argument, would encourage the LECs to be more efficient and would provide incentives for them to invest in infrastructure improvements.

Not surprisingly, CCTA agrees with those customer and competitor parties that have summarily rejected the LECs' vision of "pure" price caps. The alleged efficiency incentives of pure price caps will deliver little in the way of tangible consumer benefits if the cost savings of productivity improvements are never passed through in actual rates paid by LEC customers. Neither customers nor competitors will be better off if the LECs are able to "tax" their monopoly telephone customers (through a reduced productivity factor) to fund their infrastructure upgrades, while current and potential LEC competitors, such as competitive access providers and cable television systems, must finance their network improvements with shareholder or bondholder dollars.

The true promise of price-cap regulation will best be fulfilled if the FCC focuses its efforts on fine-tuning the parameters of the existing price-cap framework to provide a better balance between customer and LEC shareholder interests. A few simple adjustments to the current framework could yield large consumer dividends.

First, the Commission should reset the benchmark ROR to reflect the reductions in capital costs since the price-cap framework was first adopted. The new benchmark ROR should be used to update the thresholds for the sharing and low-end adjustment mechanisms and to determine the level of a one-time rate reduction that restores an appropriate balance of earnings opportunities and customer benefits.

Next, the Commission should re-examine the productivity adjustment factor and set a new target that truly requires the LECs to improve on their historical performance under traditional cost-of-service regulation. With these simple changes in place, the Commission's existing price-cap framework can work as originally intended to provide greater incentives for LEC efficiency, while providing lower rates for customers than would have been possible under traditional cost-of-service regulation.

CCTA provides below a detailed analysis of the changes that are needed—as well as the changes that are *not* needed—in the price-cap framework. CCTA asks the Commission to make the following findings:

- To date, price-cap regulation has failed to produce rate reductions in excess of those that would have been expected due to a combination of competitive forces and the operation of traditional cost-of-service regulation.
- To ensure consumer benefits from price-cap regulation, the FCC must fine-tune the parameters of the current price-cap formula. Specifically, **the FCC must adopt a new benchmark ROR no greater than 10.00% and should consider increasing the productivity factor.**
- To provide just and reasonable rates and to avoid cross-subsidization and anti-competitive behavior, **the FCC must adopt a one-time rate reduction reflecting the difference between the new benchmark ROR and the current 11.25% benchmark ROR,** in addition to using the new benchmark ROR to reset the thresholds for the low-end adjustment and sharing mechanisms.
- To provide continued protection against the uncertainties inherent in the establishment of the price-cap parameters, especially the productivity factor, **the FCC must retain the sharing mechanism at this time.**

- To ensure that the price-cap formula works as intended, the FCC must prevent the LECs from using changes in depreciation rates to affect rates and must continue to prescribe depreciation rates to be used in calculating shareable earnings.
- To protect ratepayers against excessive rates, the FCC must not reduce its regulatory scrutiny over the LECs' prices except in those markets in which the LECs can demonstrate that at least 50 percent of customers have competitive alternatives available to them and competitors have obtained at least a 15 percent market share.

CCTA submits that these findings, and the adjustments to the price-cap framework that they embody, provide an appropriate basis for FCC regulation of LEC rates over the next three to four years. The Commission should then revisit the price-cap framework, and the environment in which the LECs compete, to determine whether further changes are warranted.

The FCC should firmly reject LEC efforts to re-link rates with LEC investment on the basis of LEC pleas that certain changes in the Commission's price cap plan (e.g. a reduction in the productivity factor) would provide greater incentives to invest in the national information infrastructure. This is contradictory to the premises of price caps, and would amount to a tax on the general public to fund the NII.

II. THE FCC MUST ENSURE THAT CONSUMERS ARE BETTER OFF UNDER PRICE-CAP REGULATION THAN THEY WOULD HAVE BEEN UNDER TRADITIONAL COST OF SERVICE REGULATION. ACHIEVING THIS OBJECTIVE REQUIRES ADJUSTMENT OF THE CURRENT PRICE-CAP PARAMETERS AND RETENTION OF THE SHARING MECHANISM.

In their opening comments, all parties acknowledged, implicitly or explicitly, that consumers must benefit from price-cap regulation if the price-cap experiment is to be judged a success. Yet most of the LECs appear to believe that consumer benefits from price-caps can be demonstrated simply by pointing to the allegedly superior incentives for LEC productivity improvement under price-caps relative to traditional cost-of-service regulation or the real price decreases that have occurred since price-caps were first instituted. These commenters have measured the performance of price-caps against inappropriate benchmarks.

The critical question is whether rates have been lower under price caps than they would have been under traditional cost-of-service regulation. Indeed, this is the intent of the FCC's price cap limits. As the Commission observed in its Notice of Proposed Rulemaking in this docket, "[t]he price cap limits are set by the Commission to assure that rates are reasonable and lower than under rate of return regulation."[2/] To determine whether the Commission has successfully accomplished this goal, one must compare rates under price-caps to the rates that would have prevailed had traditional cost-of-service regulation remained in place. If rate levels would have been as low or lower in the absence of price-caps, whether due to competitive forces or the operation of

[2/] Notice of Proposed Rulemaking ("NPRM") at 4.

traditional cost-of-service regulation, then the adoption of price-cap regulation cannot be said to have had any consumer benefit.

Although it is impossible to know with certainty what rates would have been in the absence of price-caps, the record established in the opening comments suggests strongly that *both real and nominal rates for interstate LEC services would have declined over the past three years under traditional cost-of-service regulation*. First, as some LEC commenters acknowledge, the rate reductions that have occurred over the past three years have often been attributable to competitive forces, rather than the operation of the price-cap formula.[3/] These competitive forces would have compelled the LECs to seek rate reductions under traditional cost-of-service regulation as well. Competitively motivated rate reductions cannot be cited as a consumer benefit of price-cap regulation.

Second, given prevailing economic conditions over the past three years, there can be little doubt that traditional cost-of-service regulation would have required decreases in LEC rates. Virtually every component of LEC revenue requirements has declined or, at a minimum, remained stable over the past three years. Overall inflation rates were extremely low during this period, and the analysis conducted by Economics and Technology, Inc., ("ETI") for the Ad Hoc Telecommunications Users Committee indicates that input price inflation for LECs is typically less than that for the

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[3/]GTE's Comments at 14; *see also* Comments of Ameritech at 1, acknowledging that Ameritech's rates overall are below the price-cap ceilings.

economy as a whole.[4] LEC labor forces shrank, and much of this force reduction would undoubtedly have occurred even without price-caps, as an essential response to the competitive forces that the LEC commenters have documented in their opening comments.[5] New LEC capital investments were largely offset by depreciation of the existing capital stock, and in some cases fell below the level of depreciation.[6] And, as the Commission itself observed in the NPRM, interest rates and capital costs declined precipitously.[7]

Under these conditions, the LECs undoubtedly would have gone forward with the refinancing of high-cost debt and would have experienced a lower cost of equity as well. Furthermore, if the LEC commenters are to be believed, the cost of equity would have been lower still under traditional cost-of-service regulation because price-cap regulation allegedly increases LEC risk, and thus the cost of equity capital.[8]

On balance, CCTA sees little reason to believe that the rate reductions that have occurred to date under the federal price-caps framework are any larger than those that would have occurred under traditional cost-of-service regulation. Indeed, they may actually

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[4] Dr. Lee L. Selwyn, Dr. David J. Roddy, Susan M. Gately, Scott C. Lundquist and Sonia N. Jorge, "LEC Price Caps: Fixing the Problems and Fulfilling the Promise," Attachment A to Comments of the Ad Hoc Telecommunications Users Committee, at 67. Hereinafter referred to as ETI Report.

[5] *See, e.g.*, NYNEX Comments at 13.

[6] ETI Report at 67-68.

[7] NPRM at 19; ETI Report at Figure 5.

[8] *See, e.g.*, Comments of Pacific Bell and Nevada Bell at 45.

be smaller. Certainly, the FCC has no reason to be complacent about the pro-consumer effects of price-caps merely because nominal rates have declined over the past three years.

Nor can the FCC justify the continued application of its current price-cap framework based on the LECs' claim that price-caps produce superior incentives for LEC productivity improvements. From a consumer perspective, LEC productivity gains under price-caps are important only insofar as they produce decreases in telephone rates or increases in the quality of LEC service relative to the performance expected under cost-of-service regulation. The LECs have failed to demonstrate that customers, not just LEC shareholders, have benefitted from price-cap-induced productivity gains. The challenge that the FCC faces in this review of the LEC price-cap framework is to fine-tune the price-cap parameters to ensure that consumers fare better under price-caps over the next several years than they have for the past three years.

A. The FCC Should Adopt a Lower Benchmark Rate of Return to Reflect Reduced Capital Costs and Should Use This Lower Benchmark Return Both to Reset the Sharing and Low-End Adjustment Earnings Thresholds and to Reset Current Rate Levels

1. The FCC Should Adopt a Benchmark Rate of Return of No Greater Than the 10.00% Benchmark Return Recently Adopted by the California Public Utilities Commission in Its Price-Cap Review Proceeding

The first parameter of the price-cap framework that the FCC should fine-tune is the benchmark ROR, which is currently set at 11.25%. In its first triennial review of the California intrastate price-cap plan, the CPUC recently reset the "market-based" rate of return used in Pacific Bell's intrastate price-cap mechanism at 10.00%, based on an extensive evidentiary record regarding changes in capital costs for LECs in general since 1989.[9] In reaching its decision, the CPUC explicitly considered and rejected the testimony of Pacific Bell witness Dr. James Vander Weide, who asserted that the cost of capital for a LEC such as Pacific Bell had remained largely unchanged since 1989.[10] Pacific Bell has cited this same CPUC-rejected testimony as support for its opening comments regarding cost of capital in this docket.[11]

The CPUC's choice of a 10.00% "market-based" rate of return is largely consistent with the analysis and expert testimony presented by Matthew I. Kahal on behalf of MCI Telecommunications Corporation ("MCI") in this docket.[12] Using the most recent data available at the time of his May 1994 filing, Kahal recommends that the FCC adopt a 9.54% benchmark ROR. Kahal relied on the same methodology that the FCC used to arrive at its original 11.25% benchmark ROR.

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[9] California Public Utilities Commission Decision 94-06-011 (June 8, 1994), regarding review of Pacific Bell price-cap framework, at 2 (mimeo). The "market-based" rate of return is the CPUC's analog to the FCC's benchmark ROR.

[10] *Id.* at 50-51. The CPUC also found that the record did not support Dr. Vander Weide's "cellular adjustment" and rejected that adjustment as being "neither appropriate nor proper in magnitude." *Id.* at 51. Mr. Kahal's 9.54% ROR recommendation for MCI, discussed below, is premised in part on removing a similar "cellular adjustment" from the otherwise generally reasonable methodology that the FCC adopted in CC Docket No. 89-624. Statement of Matthew I. Kahal Concerning Cost of Capital on behalf of MCI Telecommunications Corporation at 7 (hereinafter referred to as Kahal Testimony).

[11] Comments of Pacific Bell and Nevada Bell at 45, ftn. 40.

[12] Kahal Testimony.

Specifically, he used the average capital structure for the seven Regional Bell Operating Companies as of December 31, 1993, to calculate a weighted average of the 11.00% cost of equity resulting from his Discounted Cash Flow ("DCF") analysis and the actual 1992 embedded debt cost for Bell local exchange companies of 8.00%.

CCTA's economic expert, Ms. Murray, has reviewed Kahal's methodology and analysis and finds that Kahal presents a credible estimate of the LECs' cost of capital. Her review indicates that, if anything, Kahal has somewhat *overstated* the true cost of capital through his selection of certain input data for the DCF model.[13/] Thus, CCTA believes that the FCC can be confident that the correct cost of capital factor is no higher than Kahal's 9.54% estimate.[14/]

2. <u>The FCC Should Use the New Benchmark ROR to Reset the Earnings Thresholds for the Low-End Adjustment and Sharing Mechanisms of the Price-Cap Framework</u>

Having set a new benchmark ROR, the Commission must then adjust several parameters of its price-cap framework to comport with its revised estimate of the cost of capital to the LECs. The threshold earnings levels for both the low-end adjustment mechanism and the sharing mechanism were originally established with reference to the 11.25% benchmark ROR. They should be adjusted

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[13/] *See* Reply Affidavit of Terry L. Murray, Attachment 1, at 2.

[14/] Kahal's testimony in the opening round indicated that he will be updating his analysis in this round of comments. Assuming that he uses the same methodology and merely adds more recent information about stock prices and other model inputs, CCTA accepts Kahal's updated analysis as providing the best upper-bound estimate of the LECs' cost of capital for use in the price-cap formula.

downward by the difference between 11.25% benchmark and the new benchmark ROR (*e.g.*, they should be reduced by 171 basis points if the FCC adopts Kahal's recommended benchmark ROR of 9.54%).

This adjustment has precedent in the recent California price-cap review. In that proceeding, the CPUC reduced its comparable "floor" and "ceiling" RORs by 150 basis points to reflect the decrease in its adopted "market-based" ROR from 11.50% to 10.00%.[15/] Although Pacific Bell disputed the level of the new "market-based" ROR, it conceded the appropriateness of adjusting the floor and ceiling RORs to reflect any changes in the CPUC's adopted "market-based" ROR.

Failure to reset the low-end adjustment and sharing thresholds could lead to absurd results. For example, if the benchmark ROR fell to a level below the previously adopted threshold for the low-end adjustment mechanism, the LECs could obtain automatic rate increases even if their earnings exceeded the benchmark ROR. This concern is not merely academic. MCI notes that the 9.54% benchmark ROR derived from the analysis of Mr. Kahal "is almost 75 basis points below the low-end adjustment mechanism that entitles price cap carriers to increase rates to recoup [a] return of 10.25%."[16/] To maintain the overall balance of its regulatory scheme, the FCC must reset the low-end adjustment and sharing thresholds whenever it sets a new benchmark ROR.

[15/]CPUC D.94-06-011 (June 8, 1994) at 2 (mimeo).

[16/]Comments of MCI Telecommunications Corporation at 3.

3. The FCC Should Adjust Rates Downward to Reflect the Decrease in Capital Costs As Measured by the New Benchmark ROR

A second, and more controversial, function of the new benchmark ROR is the adjustment of rates to reflect the new, lower cost of capital. The LEC commenters (unsurprisingly) uniformly reject the concept of a one-time rate reduction to reflect lower capital costs, arguing that such a rate adjustment would be tantamount to a retreat to traditional cost-of-service regulation. Bell Atlantic's comments are typical of the LECs' reaction to the proposed one-time rate reduction.

> [I]ncluding a one-time price adjustment or examination of LEC earnings as part of the current review is inappropriate. Any action based on LEC costs or earnings would destroy the very incentives that price caps seek to create. The message to LECs would be that unsuccessful efforts to innovate and become more efficient will be rewarded with higher rates, while successful efforts will be punished by regulatory attempts to recapture the benefits with reduced rates. In short, this effectively means a full scale return to rate of return regulation and all the harmful incentives it creates.
>
> Likewise, adjusting prices for changes in interest rates would be a step backward toward cost of service regulation, and should be rejected out of hand.[17/]

These arguments are simply wrong. An adjustment of rate levels to reflect the difference between the current 11.25% benchmark ROR and a newly adopted benchmark ROR of 10.00% or less would be no different in its effect on LEC incentives than the current annual adjustment that reflects the effect of annual updates in the inflation rate. In both cases, the adjustments reflect changes in general economic conditions outside the LECs'

[17/]Bell Atlantic Comments at 12-13 (footnotes omitted).

control. In neither case is the adjustment based on actual LEC earnings or performance.

The FCC must adjust rates to reflect reduced capital costs in order to ensure that rates paid by consumers are just and reasonable. Failure to flow through a reduction in capital costs would enable the LECs to achieve earnings in excess of the benchmark ROR even if their efficiency gains fell short of the productivity factor. In such circumstances, earnings in excess of the benchmark rate of return would truly constitute excess profits. As a matter of public policy, the presence of excess profits must be considered as evidence that rates are *not* just and reasonable.

Of course, the LECs' books might not reflect earnings in excess of the benchmark rate of return because they might choose to "spend" their excess profits by subsidizing competitive rates. By so doing, they could achieve acceptable overall returns while engaging in predatory pricing, and later reap the benefit of even greater excess profits when predatory pricing succeeds in driving rivals out of competitive markets. Thus, a second important reason to require a one-time rate reduction is to avoid cross-subsidization and anti-competitive behavior by the LECs.

The LECs insist that a one-time rate reduction to reflect reduced capital costs would be tantamount to "double-counting" because the decline in capital costs is already reflected in the inflation component of the price-cap formula. In Pacific Bell's words,

> Adjusting rates or sharing thresholds is unnecessary to reflect changes in the cost of money and would amount to double-counting. The GNP-PI is an output index that measures inflation for the overall U.S. economy. As such, it reflects the changes in the costs of all inputs to the production process. This includes all the factors, including interest rates, that affect labor costs, nonlabor costs and capital costs.[18]

At best, the LEC commenters are only partially correct. LECs are disproportionately capital-intensive enterprises, and benefit from reduced capital costs to a far greater degree than do firms in the economy as a whole. Evidence from the recent California price-cap review indicates that capital costs are 65 percent of total costs for the telecommunications industry, but are only 25 percent of total costs for the economy as a whole.[19] Thus, even to the extent that changes in capital costs are captured by the inflation index in the price-cap formula, those changes will be weighted by the 25 percent economy-wide "share" of capital, rather than the 65 percent telecommunications industry "share" of capital as a percentage of total costs. Allowing the LECs to retain the disproportionately large benefits they gain from declines in interest rates would unfairly tilt the balance of price-cap regulation in favor of LEC shareholders and away from LEC customers.

Furthermore, LECs are able to obtain significant amounts of very long-term, fixed-rate debt. As a result, they continue to

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[18] Comments of Pacific Bell and Nevada Bell at 45.

[19] Testimony of Dr. Ernst R. Berndt in CPUC price-cap review docket, Application Nos. 92-05-002 and 92-05-004, Tr. at 2183-2189.

benefit from decreased capital costs long after interest rates rise again. Because most other firms do not enjoy comparable access to long-term, fixed-rate financing, the inflation index in future years will not accurately reflect the persistent effects of LEC debt refinancings during periods of low interest rates.[20] Unless the FCC adopts a one-time rate reduction to reflect the effects of the decline in interest rates over the past three years, the LECs will achieve windfall profits in future years as the inflation index systematically overstates the increase in costs that they experience.

B. The FCC Should Consider Adopting a Higher Productivity Factor to Create a More Reasonable and Balanced Price-Cap Framework

In their opening comments, the LECs have generally sought to maintain or to decrease the productivity offset currently in place. For example, U.S. West is willing to maintain the current 3.3% productivity offset (subject to the elimination of the sharing mechanism), but characterizes the 3.3% target as a "formidable challenge to price cap LECs."[21] By contrast, Bell Atlantic argues that 1.7% "should be the absolute ceiling for any [productivity] offset adopted here."[22] The evidence and analysis presented by

[20]MCI witness Kahal noted in his opening testimony that the embedded cost of LEC debt rises very slowly in response to increases in interest rates. Kahal Testimony at 23.

[21]U.S. West Comments at 36.

[22]Comments of Bell Atlantic at 15.

other commenters, most notably in the ETI Report, supports an increase in the productivity offset.

In these reply comments, CCTA will not address the merits of the "dueling" Total Factor Productivity ("TFP") studies themselves; instead, we will first discuss the relevance of historical TFP studies to the selection of a productivity factor for the next price-cap period and then respond to the LECs' claims that the productivity factor must be kept low to enhance LEC efficiency incentives and to promote LEC investment in the "information superhighway."

1. Historical TFP Results May Grossly Understate the LECs' Expected Productivity Gains Over the Next Several Years and Thus Should Be Used with Caution in Setting the Price-Cap Productivity Factor

The LECs have staked their claim to a constant or reduced price-cap productivity factor on an analysis performed by Christensen Associates for USTA. The Christensen Associates study compares the productivity gains achieved by the LECs with those for the economy as a whole for the period 1984-1992. This study concludes that the LECs experienced a differential productivity of 1.7% (*i.e.*, the LECs' average TFP results over the 1984-1992 period exceeded the economywide TFP results by an annual average of 1.7%).[23/] Because this figure is well below even the 3.3% minimum productivity offset required for the first price-cap period, the

[23/]Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, "Productivity of the Local Telephone Operating Companies Subject to Price Cap Regulation," USTA Comments, Attachment 6 at ii (hereinafter referred to as Christensen Associates Report).

LECs conclude that the current productivity target should certainly not be increased, and perhaps should even be decreased.

Whether one accepts the Christensen Associates result or the much higher historical TFP estimates contained in the ETI Report as the best estimate of *past* productivity achievements, it is still necessary to ask whether the historical results are the best predictors of *future* productivity gains. There are at least two reasons to question the simple equation of historical productivity with future productivity.

First, and most important, historical productivity achievements are at best a poor predictor of future productivity gains if the technology used to provide telecommunications services changes significantly from the technology used in the historical period studied. In this regard, the FCC must take note of the LECs' plans to install radically different local networks, based on fiber and coaxial cable technologies. At least one LEC, Pacific Bell, has attempted to justify installation of its new network on the basis of the significant cost advantages its hybrid fiber-coax network will have for telecommunications services. In fact, Dr. Robert Harris (who has testified in this docket on behalf of USTA) has previously testified before this Commission that Pacific Bell's new network will produce capital cost savings of 32% and operations and maintenance savings of $50 per subscriber per year compared to the current copper-based technology for local telecommunications